Draft ATO guidance on new transfer pricing rules

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The Australian Taxation Office (ATO) has recently released draft guidance on the new transfer pricing rules that were enacted in 2013. The guidance addresses the topics of documentation, penalties, and the circumstances in which the law requires actual dealings to be disregarded and 'reconstructed' with hypothetical arm's length dealings.

Although the guidance sheds some light on how the ATO will apply certain aspects of the new rules, much of the content does not go beyond what was included in the explanatory memorandum to the enacting legislation and there are several interpretative questions that remain unanswered.

This *TaxTalk* article provides a brief summary of key aspects of the new guidance.

The ATO's draft guidance was issued in the form of two draft rulings and two draft practice statements. These are:

1. Taxation Ruling 2014/D3: Income tax: transfer pricing – the application of section 815-130 of the Income Tax Assessment Act 1997 (TR 2014/D3)
2. Taxation Ruling 2014/D4: Income tax: transfer pricing: documentation requirements (TR 2014/D4)
3. PS LA 3672: Administering transfer pricing penalties for income years commencing on or after 29 June 2013
4. PS LA 3673: Guidance for transfer pricing documentation

TR 2014/D3 outlines the ATO's views on the 'reconstruction' rules. The documentation draft ruling (TR 2014/D4) and the draft practice statements on documentation (PS LA 3673) and penalties (PS LA 3672) are intended to be read together.

In line with the date of effect of the new transfer pricing laws, the rulings and practice statements, when finalised, will apply to transfer pricing matters relating to years beginning on or after 29 June 2013.

Reconstruction

The new transfer pricing rules require taxpayers to consider whether their transactions must be priced under the basic rule (which essentially involves identifying an arm's length price for the actual transaction as it was conducted), or one of three exceptions, which may require the actual dealings to be disregarded in whole or in part, and potentially 'reconstructed' by substituting hypothetical arm's length arrangements.

The three exceptions to the basic rule are:

1. Where the form and substance of the actual commercial and financial relations differ
2. Where independent entities would have entered into commercial or financial. relations which differ in substance from the actual commercial or financial relations
3. Where independent entities would not have entered into commercial or financial relations at all.

The Transfer Pricing Guidelines published by the Organisation for Economic Co-operation and Development (OECD Transfer Pricing Guidelines) state that reconstruction of dealings should only occur in 'exceptional circumstances.'

TR 2014/D3 reinforces that this is the intention of the ATO, stating that in most cases the arm's length conditions will be able to be identified by applying the basic rule.

The draft ruling provides guidance on factors that are relevant for identifying the 'substance' of commercial or financial relations, such as whether the relations make commercial and financial sense. The draft ruling also provides examples to illustrate situations which the ATO considers to fall within one of the three exceptions. The application of the reconstruction rules will be heavily dependent upon the facts, so taxpayers will need to consider the provisions in light of their own particular facts to conclude on whether they should apply the basic rule or one of the exceptions.

Documentation

A key change under the new laws was to introduce a requirement for transfer pricing documentation to be prepared by the time of lodging the relevant tax return to be able to establish a reasonably arguable position (RAP) in relation to a transfer pricing matter. Whether or not a RAP exists will impact the penalty rate that may apply if the ATO issues an amended assessment (see further discussion under the *Penalties* heading below).

Key points covered in the documentation guidance materials include:

- The ATO view is that documentation must be 'brought into existence' by the time of lodging the tax return for it to meet the requirement that it was 'prepared' at the time of lodgement. The ruling is silent on whether a draft is acceptable.
- If prepared overseas, documentation must meet the requirements of the Australian law and be freely accessible to the Australian taxpayer. The Australian taxpayer should review the documentation to confirm it meets the requirements.
- Taxpayers are encouraged to perform a risk assessment to determine what documentation they require. No further guidance is provided on how this assessment should be performed.
- The ATO expects documentation to explicitly consider the potential application of the reconstruction rules (i.e. the documentation must consider whether any of the exceptions to the basic rule could apply to the arrangement).
- Where the thin capitalisation rules apply, it will be necessary for the taxpayer's documentation to consider section 815-140 of the *Income Tax Assessment Act* 1997 (which deals with the interaction of the thin capitalisation and transfer pricing rules). No detail is provided on how this is expected to be done, although there is an example in TR 2014/D3 which refers to section 815-140 and further examples were also included in the explanatory memorandum.
- The Commissioner's view is that identifying arm's length conditions involves hypothesising, on the basis of reliable evidence, what third parties in similar circumstances would have done. It is clear that at a minimum, this involves selecting and applying the most appropriate and reliable transfer pricing method, but it is not clear how much further the ATO expects taxpayers to go in hypothesising what third parties would have done differently in structuring a comparable arrangement.
- Other than addressing the particular requirements of the new law (such as the reconstruction rules), the documentation process recommended by the ATO is not significantly different from the ATO's previous guidance.
- The new guidance provides less detail on matters such as method selection and comparability than was contained in previous transfer pricing rulings. This seems to be an acknowledgement that it is not necessary now for the ATO's guidance to replicate detail that is covered in the OECD Transfer Pricing Guidelines.
- In line with a broader trend we are observing globally, including as part of the OECD's discussion drafts on transfer pricing documentation and country by country reporting, the ATO suggests documentation should include various items of information about how the Australian operations fit within the 'bigger picture' of the global operations of

the multinational group. The ATO acknowledges that detail about offshore related parties may not always be available to an Australian subsidiary.

- The need to establish a process for reviewing, monitoring and updating transfer prices is discussed, but there is no explicit guidance on the level of effort required on an annual basis.

Penalties

The draft practice statement on penalties provides a useful explanation of how the ATO will apply penalties when it issues an amended assessment in relation to a transfer pricing matter, but this is largely consistent with the approach applied under the old transfer pricing rules.

The only notable change in relation to penalties is the requirement to prepare transfer pricing documentation to be able to establish a RAP, as mentioned above. Under the new rules, a taxpayer cannot have a RAP in relation to a transfer pricing matter if it did not prepare documentation prior to lodgement of the relevant income tax return. To establish a RAP, the taxpayer must also pass the general RAP test, which requires that the taxpayer's position is "about as likely to be correct as incorrect, or is more likely to be correct than incorrect." The draft practice statement does not provide further detail on how this test may be applied in a transfer pricing context.

The penalty rate that generally applies where a taxpayer does not have a RAP is 25 per cent of the 'tax shortfall'. This rate is reduced to 10 per cent of the tax shortfall where the taxpayer has a RAP.

Key considerations

Preparing documentation on a timely basis is critical for penalty protection purposes, so any multinationals which have not yet considered their Australian transfer pricing documentation, should do so as early as possible before the first tax return under the new rules is due. Many multinationals with operations in Australia have already begun planning and/or preparing the transfer pricing documentation required to comply with the new rules. The ATO's draft guidance will help those taxpayers to assess whether their approach is consistent with the ATO's expectations, although there are likely to be aspects of the documentation where judgement is required to determine what the law requires.

Comments on the draft guidance are due on 30 May 2014. It is likely that the final guidance will then be issued sometime in the second half of 2014.

Let's talk

For a deeper discussion of how these issues might affect your business, please contact:

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